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STATE FOR WHA/MEX, WHA/EPSC  
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SUBJECT: THE MEXICAN RETAIL SECTOR: A LOOK AHEAD.

¶1. (SBU) SUMMARY: The Mexican retail sector is expected to grow aggressively in 2006-2007, driven by rising demand for low-cost goods coupled with expansion into previously underserved areas. Econoff met with industry representatives and government officials who confirmed their widespread expectation of continued growth. However, American firms such as WalMex (Wal-Mart's Mexican operation) and Costco likely will face increased challenges including new possible government regulation, nationalistic licensing policies, and increasingly competitive Mexican chains armed with a more sophisticated distribution system. A greater presence by Chinese suppliers may also pressure prices and profit margins downward. END SUMMARY.

THE TIP OF THE ICEBERG  
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¶2. (SBU) According to unpublished data from the National Institute of Statistics (INEGI), the Mexican retail sector grew by 3.6% in 2005, and by a 3.0% annualized rate in January, 2006. Overall employment in the sector increased from 774,600 in January, 2001 to 869,290 in January, 2006, nearly 11%. One researcher for INEGI informed Econoff that the amount of overall retail tax revenue collected outside of Mexico City has risen from 37% in 2001 to 45% in 2005, suggesting significant expansion of commercial retail activity in smaller communities. Indeed, most industry participants agreed that the informal (unregistered) retail market still accounted for approximately 50% of the total retail activity in Mexico, and is especially prevalent in rural areas, suggesting that continued growth in these locations is likely.

COSTCO STAYS THE COURSE  
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¶3. (SBU) Mauricio Talayero, Director of Administration and Finance for Costco Mexico, told Econoff that warehouse-style retailer Costco is planning to open two additional warehouses in 2006 by following the expansion plan devised in 1993. The plan terminates in 2015, when Costco is expected to have 68 stores, compared to 28 in 2005. While maintaining their core strategy of targeting high-income shoppers, Mr. Talayero described a future corporate emphasis on direct business-to-business sales. An example of this strategy is a planned warehouse in Uruapan, a relatively small metropolitan area (population 225,900) in the relatively rural state of Michoacan with a much lower median income level than traditional Costco target areas. However, Uruapan contains numerous small businesses, most of which currently depend on small, family owned suppliers. Talayero also stated that even though Costco has a competitive advantage selling

primarily U.S. goods (generally believed in Mexico to be of higher quality), the Mexican supermarket company Soriana has recently entered the market niche by launching several warehouses directly marketing to Costco customers.

#### BIG WHEELS KEEP ON ROLLIN'

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14. (SBU) Francisco Suarez, Vice-President of Institutional Relations, confirmed to Econoff that WalMex will open 120 outlets in 2006; 80 Wal-Marts and 40 Bodega Aurrerás (a discount warehouse). While also searching for less developed areas, WalMex is (along with Costco) hoping to capitalize on the untapped purchasing power of Mexican small business with specific business-to-business programs such as "Mi Tiendita," and "Mi Cafeteria." Suarez also recognized Soriana as the most competitive rival, due to a reputation as the "Mexican hometown store," as well as their strong distribution system. However, he pointed out an internal study which showed that Mexico's retail sector was only 40-50% saturated, offering great opportunity. WalMex, stated Suarez, "was ready to take care of business."

#### THE ONLY REAL THREAT

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15. (SBU) While demonstrating growing sales totals that surpass the combined competition (up 3.9% in February 2006 compared with February 2005), according to Suarez, WalMex's growth could be restricted by government policies which limit competition in the sector, traditionally one of the freest areas of the Mexican economy. Suarez also privately admitted that the proposed "Commercial Practice Initiative," temporarily defeated in the Chamber of Deputies (due in part to a huge lobbying effort by WalMex), will likely resurface in 2007 in a more nationalistic context. The initiative has two main facets; limitation of store construction to sites "consistent with Mexican interests" and approved by a federal regulatory board, and a prohibition against selling products below cost (a common technique utilized by WalMex to capture market share). Both elements were described by Suarez as the only real threat confronting WalMex, as he stated that "our top priority at WalMex is ensuring competition everywhere."

#### AND IN THE OTHER CORNER...

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16. (SBU) Arturo Monroy, Director General of the National Association of Retailers (ANAM) told Econoff that his organization, which is lobbying heavily for the initiative, represents 111 retail chains (all Mexican) locked in competition with "autoservicios" (WalMex, Costco). Monroy could not predict the likelihood of the initiative being passed in 2007 (due to the uncertainty of the election in 2006), but it is one of the highest priorities for ANAM. Monroy described the future for his clients; synchronized distribution centers and networks, state of the art technological platforms, and more effective marketing of their natural competitive advantage, their "Mexicanness." Admitting that the competition from WalMex had resulted in the reorganization of his clients as well as discounted prices and smaller profit margins, Monroy also voiced concern about the flood of Chinese products (many of whom escape import taxes) and their deleterious effect upon Mexican suppliers. Similar to WalMex and Costco, many of ANAM's clients are focused on expanding into medium sized markets with lower income levels.

#### PROMOTING "MEXICAN" RETAIL EXPANSION

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17. (SBU) Recognizing potential rewards, such as lower unemployment and prices, state and municipal governments throughout Mexico are aggressively promoting the opening of retail supercenters targeted to medium sized population centers. The Secretary of Economic Development for the state of Mexico, Laila Chemor Sanchez, and her advisor for retail development, Hector Garcia described for Econoff state

programs designed to encourage economic growth in previously underserved communities. According to both, retail development is easier and faster to achieve than industrial development, and is therefore a top priority. Garcia also informed Econoff that a vast majority of over 400 business license petitions issued in 2005 from the state of Mexico were from the retail sector. Privately, Mr. Garcia acknowledged a confidential but clear directive from the Governor to "encourage and promote" Mexican chains over foreign firms, if other factors were equal (which is often not the case). Garcia admitted to Econoff that this policy was highly divisive, and would probably be a controversial subject within the government in the immediate future. It can be reasonably assumed that this policy is not unique to the State of Mexico.

#### A "PYRAMID" OF LOCAL DEVELOPMENT

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18. (SBU) It has been 17 months since San Juan de Teotihuacan, a city of 50,000 inhabitants (with another 50,000 living in nearby communities) located adjacent to the famous archeological site of Teotihuacan, made international headlines by hosting the opening of a Bodega Aurrera. This medium sized city, until 2004 lacking any retail store over 20,000 square feet in size, now possesses a "hypermarket" of over 80,000 square feet. San Juan de Teotihuacan therefore can illustrate the potential effects of the type of retail expansion likely to become commonplace in Mexico. Econoff met with the general manager of Bodega as well as the mayor, both of whom confirmed that WalMex had already hired over 200 full-time employees, while planning to hire an additional 50 in 2006. The general manager, Raul Butron, added that sales growth had so far exceeded all expectations. The mayor, Adrian Galicia, later told Econoff privately that local retail prices had fallen 15% and the level of visitors from area communities had risen 25%, helping other businesses. Mr. Galicia was pleased because he expected the construction of a second warehouse, owned by Mexican retailer SuperPrecio, to begin within the year. Econoff inquired about possible negative effects of the Bodega, to which Galicia replied that the infrastructure (primarily the road network) was insufficient to handle the huge increase in traffic. However, he also added that a new project was being planned to address this issue.

#### COMMENT

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19. (SBU) The retail leader in Mexico is still clearly WalMex, although Mexican firms such as Soriana, Comercial Mexicana, and Chedraui are increasingly competitive. WalMex also will likely face a threat of Mexican nationalism in the form of new regulation, unprecedented in the retail sector, as well as official and unofficial government policies favoring domestic chains. Privately, executives from both camps expect several dynamic years of intense competition in 2006-2007, with intense battles fought in the Chamber of Deputies, state and municipal licensing boards, and via advertising campaigns directed at new customers in presently underserved areas. Strong expansion of the retail sector (possibly reaching 5% in 2006) will likely continue in the near future, principally targeted to medium-sized, medium-level income areas.

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